No. 77-1724

IN THE

Supreme Court of the United States

October Term, 1978

HARRY G. BURKS, Jr., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

PETITIONERS' REPLY BRIEF

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In this Reply Brief we deal with the following matters: A. the essential differences between the parties; B. the "mootness" argument; C. the specific points raised by plaintiffs.

A.

The essential differences between the parties

Respondents' Brief contains two principal contentions: (1) that disinterested directors of a mutual fund constituting less than a numerical majority of the Board, even though they be a valid quorum, can *never* terminate derivative litigation commenced by a stockholder (Respondents' Brief, Points I-III), and (2) that these particular disinterested directors, on the facts of this case, should not be permitted to terminate this particular stockholders' derivative litigation (Respondents' Brief, Point V).

The position taken by plaintiffs in Points I-III, which was substantially adopted by the Court of Appeals, is defective in its absolutism—it is an extreme position, at variance with basic principles of corporate governance, and one which could force large public mutual funds to maintain

unwarranted litigation at the command of one unrealistic or ill-motivated stockholder. Under plaintiffs' view of the matter, one stockholder can arrogate the power of the Board to himself merely by filing a derivative action naming all or a majority of the directors of the fund as defendants. Such a result would gravely undermine the role of directors, particularly disinterested directors, and would destroy an "important shareholder protection device" (See SEC Brief, p. 22).

Plaintiffs erroneously contend that defendants seek the absolute power to terminate stockholder derivative litigation. To the contrary, defendants do and always have maintained that the disinterested directors have the power *provided* they make a good faith exercise of business judgment. Implicit in that basic concept are a number of elements, all of which have been discussed in our original brief. Accordingly, plaintiffs have the matter backwards when they contend, as they do, that defendants seek an absolute out—it is plaintiffs who, under any and all circumstances, refuse to credit the disinterested directors' exercise of business judgment.

The position taken by plaintiffs in Point V, where they indiscriminately vilify the individuals in this case,* is unfounded and contrary to the record evidence. Plaintiffs' unsupported charges are in conflict with the findings of the District Court, the observations of the Court of Appeals and the position of the SEC, as will be documented below in our specific reply to Point V. Plaintiffs, alone, the "self-chosen representatives and volunteer champions" in the words of Mr. Justice Jackson,* perceive evil in this intracorporate resolution of a corporate matter. Their charges of impropriety are unfounded and becloud the important and fundamental issue before this Court.

* Plaintiffs attack not only the individuals in this case, but the entire mutual fund industry. Their criticism of the industry is based on outdated source material and the self-interested views of members of the class action bar (e.g., Messrs. Pomerantz, Bernstein, etc.). The most recent Congressional findings in this area, by the Senate Committee on Banking and Currency, at the time of the important 1970 amendments, contained the following statement (S. Rep. No. 91-184, 91st Cong., 1st Sess. at 4 (1969), reprinted in 3 U.S. Code Cong. & Ad. News 4897 at 4900 (1970)):

> "Your committee agrees 'that on the whole the investment company industry reflects diligent management by competent persons.' [footnote omitted] The high standards of conduct of the industry since 1940 in the areas specifically covered in the statute are in sharp contrast to the derelictions in the handling of other people's money regrettably present in the investment company industry in the 1920's and 1930's."

B.

The "mootness" argument

Plaintiffs suggest that the writ of *certiorari* granted in this case should be dismissed as "moot" (Respondents' Brief, p. 13). The asserted basis of this suggestion is that in 1978—more than three years after the disinterested directors exercised their business judgment to terminate this action—Anchor ceased to be the investment adviser to Fundamental and, therefore, it is no longer true that allowing this action to go forward would place Fundamental in an adversary relationship with its investment adviser.

This argument is wholly without force for several reasons: (1) the issue tendered to this Court as the basis for granting *certiorari* was whether the disinterested directors had the *power* to exercise their business judgment to terminate this derivative action—not whether one or more of the reasons relied on by the directors for doing so was good and sufficient; (2) the possibility of creating an adversary relationship was only one of many factors relied on by the disinterested directors in reaching their decision to seek termination of this action (see Petitioners' Brief,

* *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 549 (1949).

pp. 11-13), and (3) the decision of the disinterested directors should be judged in light of the circumstances at the time of their decision—no one foresaw in January 1975 that Anchor would retire from the investment advisory business in July 1978.

The proposed sale of Anchor's investment advisory business was publicly announced in February 1978; proxy statements seeking approval of a contract with the successor investment adviser were mailed to all shareholders of the funds--including plaintiffs—in June 1978; plaintiffs did not file their brief in opposition to *certiorari* until July 1978, and *certiorari* was not granted until October 1978. Plaintiffs could easily have raised this point *prior* to the granting of *certiorari*, but evidently chose not to do so until three weeks before the case was set for oral argument in this Court. Plaintiffs should not be permitted to derail consideration of this important case at the 11th hour on the basis of an alleged "change in circumstances"* which was known to them long before *certiorari* was granted and which, in any event, does not moot the fundamental issue presented by this case.

C.
Reply to Plaintiffs' Specific Points
Reply to Point I

Plaintiffs argue, in Point I A, that the "policy" of the Investment Company Act of 1940 demonstrates that the

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* *Bankers Trust Co.* v. *Mallis*, 435 U.S. 381, *reh. denied*, 436 U.S. 915 (1978), the case cited by plaintiffs in support of their "change in circumstances" argument, is inapposite. In that case, respondent, who had won in the Court of Appeals, conceded on oral argument in this Court that the Court of Appeals had erred, but argued that the decision of the Court of Appeals should be affirmed on another ground. No such concession of error by the Court of Appeals has been made by respondents in this case, nor have they changed their theory of the case, which was adopted by the Court of Appeals, i.e. that the disinterested directors lack the power to terminate this stockholders' derivative action. Furthermore, petitioners' theory and the basic issue presented have remained constant throughout the entire course of proceedings.

disinterested directors lack the power to seek to terminate stockholder derivative litigation (Respondents' Brief, pp. 16-20). In support of their argument, plaintiffs rely on Sections 1 and 17 of the Investment Company Act of 1940 —their reliance is misplaced.

Neither Section 1 nor Section 17 deals directly or indirectly with the power of disinterested directors to terminate stockholder derivative litigation which they determine to be contrary to the best interests of the fund and its shareholders.

Section 1 is merely a generalized policy statement, enunciated 38 years ago at the time of the passage of the original statute—it has no applicability whatsoever to the issue raised in this case. Section 1(b) (2), the particular subsection upon which plaintiffs rely, declares that the national public interest and the interest of investors are adversely affected

> "when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders. . . ."

Obviously, that section is not directed at situations such as the one at bar—it is addressed to self-dealing and other such abuses by insiders. Here the decision to forego litigation was made by a quorum of *outside* directors who were found by the District Court to have been "truly disinterested and independent" and by the Court of Appeals to have acted "in good faith in all that they did."

Similarly, Section 17, by its own terms, has no applicability to the issue raised in this case—that section deals, among other things, with sales to and purchases of securities from funds by insiders, borrowing of money by insiders, etc., i.e. matters not even remotely involved in this case. Section 17(h), the particular subsection on which plaintiffs rely, provides in pertinent part:

> "After one year from the effective date of this title, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office."

Plaintiffs argued below that the quorum provisions in Fundamental's by-laws violate Section 17(h) (See Appellants' Brief to the Court of Appeals, pp. 12-16). Evidently they have abandoned that extreme position and now argue merely that the quorum provisions violate the "policy" embodied in Section 17(h) (Respondents' Brief, p. 19). This borders on the absurd. Fundamental's quorum provisions are the normal, straightforward provisions found in the by-laws and/or charters of virtually every corporation of any kind, and they do not exculpate anyone from any liability. The motion by the disinterested directors to dismiss was not premised, as plaintiffs mistakenly argue, on the quorum provisions, but rather on the business judgment power and responsibility of the

directors to manage the affairs of the fund in the best interests of all shareholders.

Chabot v. *Empire Trust Co.*, 301 F.2d 458 (2d Cir. 1962) cited by plaintiffs (Respondents' Brief, pp. 19-20) is not in point. In that case, there was an express provision in a trust agreement requiring shareholders to post a bond to indemnify the trustee for costs and expenses in actions brought by shareholders against the trustee. The plaintiffs there had to post $35,000 as security in order to maintain their action. The Court held that this clause had the practical effect of shielding the trustee from liability by preventing lawsuits. The quorum provisions of Fundamental's by-laws and charter do not shield anybody from anything—they simply set forth how many directors are necessary to transact the business of the fund and, in this respect, are entirely standard.

Levitt v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965) also cited by plaintiffs (Respondents' Brief, p. 20), has nothing to do with Section 17 and has no bearing on this case. In that case, which involved the special Massachusetts shareholder demand rule, the question before the Court was whether a demand upon *shareholders* is necessary prior to the commencement of a derivative action under the Investment Company Act of 1940. *Levitt* did not deal with the question of whether *directors* can, in any event, exercise their business judgment to terminate a derivative action.

Plaintiffs next argue, in Point I B, that the powers conferred on the directors under the Investment Company Act of 1940 do not include the power to terminate stockholder derivative litigation (Respondents' Brief, pp. 20-30)—this misses the point.

As the SEC has said in its *amicus* brief filed in this case (SEC Brief, pp. 20-21):

> "The court of appeals appears to have relied on the fact that the Act does not specifically grant the disinterested directors authority to terminate ongoing derivative litigation. But the Act does not purport to withdraw such powers either, and it does not set out every duty and power of such directors. When Congress intended to eliminate the authority of the company's directors under the Act, it did so expressly.
>
> * * *
>
> Although Congress could have prohibited the disinterested directors from exercising business judgment in the circumstances of this case, it did not do so."

In support of their argument in Point I B, plaintiffs grossly misstate the findings of the Senate Report (Respondents' Brief, p. 24). Thus, plaintiffs state that the Senate Report "found that disinterested directors of mutual funds had no real independence from the adviser . . ." and that "Congress concluded that the disinterested directors were not sufficiently independent to protect shareholder interests in this regard." In support of their claim, plaintiffs cite page 4901 of the reprint of the Senate Report. Examination of that page reveals no such finding or conclusion by the Committee. Furthermore, plaintiffs' statements distort the entire thrust of the 1970 amendments. The concept of "disinterested" directors, with considerably stiffer requirements for qualification, was introduced in new Section 2(a)(19) to remedy criticisms of the prior category of "unaffiliated" directors. S. Rep. No. 91-184, 91st Cong., 1st Sess. at 32-33 (1969), reprinted in 3 U.S. Code

Cong. & Ad. News 4897 at 4927-28 (1970). Contrary to plaintiffs' misleading statements, Congress most assuredly did conclude that disinterested directors were sufficiently independent to protect shareholder interests. Again, as the SEC has said in its *amicus* brief in this case (SEC Brief, p. 22):

> ". . . The premise of the court of appeals—that disinterested directors are incapable of acting independently for the benefit of shareholders—conflicts with the congressional determination in 1970 that such directors are 'to supply an independent check on management and to provide a means for the representation of shareholder interests.' H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970)." *

Finally, the remarks of Chairman Williams of the SEC on the *Lasker* case, quoted in Respondents' Brief, pp. 28-29 n.*, were made without benefit of a reading of the record. In any event, the official position of the SEC is set forth in its *amicus* brief, from which there is no indication of a dissent by Chairman Williams.

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* See also S. Rep. No. 91-184, 91st Cong., 1st Sess. at 32-33 1969), reprinted in 3 U.S. Code Cong. & Ad. News 4897 at 4927-28 (1970):

> "The function of these provisions [prior Sections 2(a)(3) and 10] with respect to unaffiliated directors is to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.
>
> "Your committee believes that the definition of 'affiliated person' in section 2(a)(3) of the act does not adequately meet this purpose. . . .
>
> * * *
>
> "Proposed section 2(3) of this bill seeks to remedy the act's deficiencies in this regard by adding a new section 2(a)(19) to the act which would define the term 'interested person'. Other sections of the bill would substitute that term for the present term 'affiliated person' in . . . sections [10, 15 and 32(a)] of the act. . . ."

Reply to Point II

Plaintiffs argue, in Point II, that a "minority of directors" has no power to prevent or halt derivative litigation (Respondents' Brief, pp. 30-31)—this is erroneous.

The pertinent inquiry is whether or not there is a duly constituted quorum—not whether the quorum is a majority or minority of the directors. In this case 5 of 11 directors (constituting more than a quorum) acted with the full power of the Board—would plaintiffs have viewed the matter any differently if 6 of 11 had acted?— would 6 of 11 have been any more independent than 5 of 11? The numbers test that plaintiffs seek to impose is wholly artificial and has no support in applicable corporate law.

Delaware Corporation Law and Fundamental's by-laws both provide that a quorum may act with the full power of the Board. Indeed, a majority of a quorum may act with the full power of the Board—this is a fundamental principle of law which plaintiffs seek to overturn.

As the Court stated in *Benintendi* v. *Kenton Hotel*, 294 N.Y. 112, 119, 60 N.E.2d 829, 831-32 (1945):

> "the very idea of a 'quorum' is that, when that required number of persons goes into session as a body, the votes of a majority thereof are sufficient for binding action."

See also *Crowley* v. *Commodity Exchange*, 141 F.2d 182, 188-89 (2d Cir. 1944).

A quorum is empowered to act whether it is a majority or a minority of the Board. See, e.g.: *Potter* v. *Patee*, 493 S.W.2d 58, 64 (Mo. Ct. App. 1973), *motion denied; Twisp Min. & Smelt. Co.* v. *Chelan Min. Co.*, 16 Wash.2d 264, 290, 133 P.2d 300, 310-11 (1943); *Stott.* v *Stott Realty Co.*, 246 Mich, 267, 271-72, 224 N.W. 623, 624 (1929).

As the Court stated in *Twisp, supra* (16 Wash.2d at 290, 133 P.2d at 311), referring to 2 Fletcher, *Cyclopedia of Corporations* § 421:

> "A careful study of Fletcher will, in our opinion, reveal that the text recognizes that the number of directors of a corporation necessary to constitute a quorum may be fixed by the by-laws, if not incompatible with the articles or statutory law, and that a majority of that quorum may decide any question coming properly before such meeting, although the number of directors present may be less than a majority of the entire board."

Plaintiffs also argue, in Point II, that if a minority of directors could terminate stockholder derivative litigation it "would unsettle the whole doctrine of shareholder demand and excuse therefrom"—this, too, is erroneous.

First, it is simply incorrect to contend that the concept of a "majority" is an inherent or essential part of the demand rule. Rule 23.1 does not mention either a majority or a minority. There is nothing in the demand rule that bars a lawful minority quorum from passing on a demand by a putative derivative suit plaintiff. If and when a demand is made on the directors, nothing requires all the directors, or even a majority of them, to function on the demand. As with any other corporate business, in the absence of an express by-law or charter provision to the contrary, any duly constituted quorum of the Board can function in response to the demand; and, when it does, the vote of a majority of the quorum would be sufficient.

Second, demand is properly excused only when it would be "futile", not whenever a majority of the Board

is named as defendants.* In some cases, demand is futile where a majority of the Board is named as defendants, but that is not always the case. If it were, derivative plaintiffs could consign the demand rule to oblivion with the stroke of a pen by simply naming all directors defendants, irrespective of their true role in the matter. The test is: can a plaintiff allege facts that show that demand would be futile? See, e.g., *Heit* v. *Baird*, 567 F.2d 1157, 1162 (1st Cir. 1977); *In re Kauffman Mutual Fund Actions*, 479 F. 2d 257, 265 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Brooks* v. *American Export Industries*, 68 F.R.D. 506, 511 (S.D.N.Y. 1975); *Phillips* v. *Bradford*, 62 F.R.D. 681, 688 (S.D.N.Y. 1974).

The Court of Appeals held in *Heit, supra* (567 F.2d at 1162):

> "The plaintiff attempts to make up for the complaint's deficiencies in respect to Rule 23.1 by pointing out that more than a majority of the present board of directors are defendants in this suit and thereby in a position where they would not assent to its prosecution. To credit this argument, however, would be to permit an obvious bootstrap to relieve putative plaintiffs of their obligations under Rule 23.1. Merely naming disinterested directors as defendants does not allow the prosecutor of a derivative suit to avoid his duty to make a demand on them. [citation omitted]"

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* *Untermeyer* v. *Fidelity Daily Income Trust*, 580 F.2d 22 (1st Cir. 1978), relied upon by plaintiffs, does not hold to the contrary. The Court of Appeals, on the unusual facts of that case, held merely that demand was futile, and that the District Court erred in *speculating* that the interested directors, who were charged with "self-benefiting" misdeeds, would abstain from voting on the demand to sue themselves. No such issue is presented at bar.

Finally, but perhaps most important, plaintiffs misconceive the purpose and significance of the demand rule. The demand rule is designed to protect against unwarranted shareholder litigation, and to insure that whenever possible the decision to pursue or not to pursue a corporate claim is made by the Board of Directors of the corporation, whose function and responsibility it is to manage the corporation. See, e.g., *In re Kauffman Mutual Fund Actions, supra* (479 F.2d at 263). The demand rule is not a shareholder's permit to sue. Plaintiffs would have this Court rule, in effect, that satisfaction of the demand rule forever vests a shareholder with a proprietary interest in and control of the corporate claim he seeks to assert derivatively. The claim, however, belongs to the corporation, not to one or two of its stockholders, and the legally elected directors are the ones who must be able to assert continuing control over the claim.

The demand rule cannot and does not paralyze a corporation from acting or reacting to evolving circumstances after the case has been commenced. The demand rule comes into play only at the time the derivative action is commenced. *Cramer* v. *General Telephone & Elec. Corp.*, 582 F.2d 259, 276 (3d Cir. 1978).

The cases have always recognized that, so long as they act in good faith and independently, the corporation's directors have the right and power, based upon subsequent developments, to take over the claim and pursue or end it, as the directors deem best for the corporation.

Thus, the corporation itself took over the claim in *In re Penn Central Securities Litigation*, 335 F.Supp. 1026, 1040 (E.D.Pa. 1971) and in the underlying litigation which gave rise to *Alleghany Corp.* v. *Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966). And

the directors were permitted to make direct contact with the alleged wrongdoers to settle and discontinue the underlying claim, notwithstanding the pendency of the derivative action in *Wolf* v. *Barkes,* 348 F.2d 994, 997 (2d Cir.), *cert. denied,* 382 U.S. 941 (1965) and *Goodwin* v. *Castleton,* 19 Wash. 2d 748, 757-58, 144 P.2d 725, 729-30 (1944). And a quorum of disinterested directors was permitted to take other corporate action to remove the basis for the claim and thus compel termination of a derivative action against insiders in *Blish* v. *Thompson Automatic Arms Corporation,* 30 Del.Ch. 538, 583, 64 A.2d 581, 604 (1948). See also: *Meyer* v. *Fleming,* 327 U.S. 161, 167-68 (1946); *Nelson* v. *Pacific Southwest Airlines,* 399 F.Supp. 1025, 1031 (S.D.Cal. 1975).

The rule proposed by plaintiffs would allow one or two dissentient stockholders to force the corporation on an unalterable course regardless of whether that course continues to be in the best interests of the corporation. Such a rule might unwisely commit the corporation to action not in its best interests. As the Court stated in *Goodwin, supra* (19 Wash. 2d at 763-64, 144 P.2d at 732-33):

> "The mere circumstances that a lone stockholder, or a group of such individuals, has initiated a derivative action, and has alleged the existence of facts entitling him or them to maintain the suit in place of the corporation, do not of themselves establish the propriety of the action or the necessity for its continued maintenance, for otherwise, by this device the corporation, its officers, and directors, and the majority stockholders would at once be conclusively shorn of their powers of management and discretion in the conduct of those affairs which are of vital concern to the corporation and all its stockholders.
>
> * * *

> " . . . Their right in such matters is not completely forestalled by the mere fact that a single stockholder or a group of stockholders has taken the initiative by instituting a derivative action."

In *Blish, supra* (30 Del. Ch. 538, 64 A.2d 581), two years after a derivative action had been filed to nullify certain transfers of stock to two of the inside directors, a quorum of disinterested directors met and voted to ratify the issuance of the shares, thereby mooting and effecting termination of the derivative action. The Supreme Court of Delaware upeld the action of the distinterested directors which had the effect of terminating the derivative action even though the action had been validly commenced and was not frivolous, stating (30 Del. Ch. at 583, 64 A.2d at 604):

> "The contention made by the appellant that the . . . ratification was ineffective, since such occurred subsequent to the day that this suit was instituted below, is without merit. Courts generally look with apprehension upon ratification of previous corporate acts after an action has been instituted questioning the validity of such acts. However, in the absence of fraud, subsequent action by the Board within director authority will be held to be valid."

The relationship of the demand rule to the business judgment power of the directors was properly recognized in *Nelson, supra* (399 F.Supp. 1025). Whether a demand must be made is determined at the outset of the action, i.e., when the claim is first asserted. The fact that the composition of the Board may change thereafter, so that demand would no longer be futile, does not necessarily

require the shareholder plaintiff to make a new demand.* However, the new directors can, on their own initiative, determine the future course of the action (399 F. Supp. at 1031):

> ". . . the plaintiffs are not required to seek to have the new directors intervene in the suit. Though the plaintiffs may be bound by the decision of the board, it is the board itself which must initiate such activity. [citation omitted]"

At bar, of course, the directors did themselves initiate the activity at issue, i.e., the motion to dismiss.

Reply to Point III

Plaintiffs argue, in Point III A, that under Delaware law a minority of directors cannot prevent commencement of a derivative action, and, therefore, should not be permitted to effect a termination of a derivative action, i.e., that "Delaware precedents are the same as under Federal Rule 23.1" (Respondents' Brief, pp. 35-36).** None of the cases cited by plaintiffs at pp. 35-36 of their brief deals with the business judgment powers of directors. Applicable Delaware authority clearly recognizes the power of a quorum of the directors to manage the affairs of the corporation, including the power to make decisions to prosecute or cause the termination of litigation on behalf of the corporation. *McKee* v. *Rogers,* 18 Del. Ch. 81, 85-86, 156 A. 191, 193 (Ch. 1931). See also: *Blish* v. *Thompson*

* If, however, the plaintiff files an amended complaint or seeks to assert a new claim after the composition of the Board has changed, a new demand is necessary. See, e.g., *Brody* v. *Chemical Bank,* 482 F.2d 1111 (2d Cir.), *cert. denied,* 414 U.S. 1104 (1973).

** As shown *supra,* Reply to Point II, plaintiffs are in error in their argument that satisfaction of Rule 23.1 by a derivative plaintiff forever after renders directors powerless to act in the best interests of the corporation.

Automatic Arms Corp., 30 Del. Ch. 538, 583, 64 A.2d 581, 604 (1948).

Plaintiffs also argue, in Point III A, that under Delaware law directors may not ratify a fraud (Respondents' Brief, pp. 36-38). This argument misses the point. First, there was no fraud here, but only an investment loss in the ordinary course of operations. Second, the directors did not ratify anything; they exercised their business judgment in what they believed to be the best interests of Fundamental. The courts have repeatedly rejected this argument advanced by plaintiffs, and recognized that

> "The question whether it is good judgment to sue is quite apart from the question of ratification."

S. Solomont & Sons Trust, Inc. v. *New England Theatres Operating Corp.,* 326 Mass. 99, 111, 93 N.E.2d 241, 247 (1950). Accord: *Kessler & Co.* v. *Ensley Co.,* 129 F. 397, 399 (C.C.N.D. Ala. 1904); *Gall* v. *Exxon Corp.,* 418 F.Supp. 508, 518n.18 (S.D.N.Y. 1976). The District Court also correctly drew this distinction (A.19), and the Court of Appeals did not disturb this portion of the District Court's opinion.*

* The plaintiffs' argument, moreover, overlooks the numerous cases where the courts have upheld the power of disinterested directors not to pursue litigation, even though arguably nonratifiable conduct was at issue. See, e.g., *Brody* v. *Chemical Bank,* 517 F.2d 932 (2d Cir. 1975) (involving federal securities acts and fraud claims); *Alleghany Corp.* v. *Kirby,* 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28 (1966) (involving fraud claims); *Swanson* v. *Traer,* 249 F.2d 854, 859 (7th Cir. 1957) (involving fraudulent conspiracy); *Gall* v. *Exxon Corp.,* 418 F.Supp. 508, 516 (S.D.N.Y. 1976) (involving illegal payments); *Goodwin* v. *Castleton,* 19 Wash.2d 748, 764, 144 P.2d 725, 733 (1944) (involving fraud claims). Plaintiffs' reliance on *Mayer* v. *Adams,* 37 Del.Ch. 298, 141 A.2d 458 (1958), is misplaced. The only issue presented in *Mayer* was the necessity for a demand on *shareholders;* the role of *directors* in deciding whether to pursue proposed derivative claims was not an issue. Finally, plaintiffs' use of Professor Folk (Respondents' Brief, p. 39 n.*) is misleading: he was obviously talking about fraud in the exercise of business judgment, not fraud in the underlying claim. See Folk, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 76 (1972).

Plaintiffs argue, in Point III B, that federal law governs the power of the directors to exercise their business judgment to terminate derivative litigation (Respondents' Brief, pp. 39-42). As indicated in our prior brief, we believe that under the principles of *Santa Fe* and *Cort* state law should be applied here. However, it matters not—the result is the same under federal or state law: a quorum of disinterested directors has the power to terminate stockholder derivative litigation which it, in good faith, determines to be contrary to the best interests of the fund and its shareholders. See Reply to Points I and II, pp. 4-16 and SEC Brief, pp. 20-23.

Reply to Point IV

Plaintiffs argue, in Point IV A, that Rule 23.1 requires notice to shareholders and judicial approval of the dismissal of this action (Respondents' Brief, pp. 43-50)—this is erroneous because the Rule 23.1 notice and judicial approval procedures do not apply to this situation.

Plaintiffs have misconceived the purpose of Rule 23.1 and the pertinent case law. The notice and judicial approval provisions of Rule 23.1 are intended to protect shareholders against unfair and collusive settlements of derivative suits; they do not apply to a *contested* dismissal as at bar. See, e.g., *Wolf* v. *Barkes*, 348 F.2d 994, 996-97 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965); *Katz* v. *Aspinwall*, 342 F.Supp. 286, 288 (N.D. Ala. 1971), *aff'd*, 459 F.2d 1045 (5th Cir.), *cert. denied*, 409 U.S. 1000 (1972); *Daugherty* v. *Ball*, 43 F.R.D. 329, 335 (C.D. Cal. 1967); *Marcus* v. *Textile Banking Co.*, 38 F.R.D. 185, 187 (S.D.N.Y. 1965). See also: *Hutchinson* v. *Fidelity Inv. Ass'n*, 106 F.2d 431, 436 (4th Cir. 1939); *Moreland* v. *Rucker Pharmacal Co., Inc.*, 63 F.R.D. 611, 614-15 (W.D. La. 1974); Miller, *Problems of Giving Notice in Class Actions*, 58 F.R.D. 313, 331 (1973); Simeone, *Procedural Problems of Class Suits*, 60 Mich. L.Rev. 905, 934 (1962).

As the Court stated in *Marcus, supra* (38 F.R.D. at 187), in refusing to order notice of a dismissal of a derivative suit for lack of jurisdiction:

> "'The purpose of the provision is the protection . . . against the unjust or unfair settlements in case a plaintiff who starts the action becomes faint-hearted before its completion or secures satisfaction of his individual claims by compromise.' [citation omitted]"

Similarly, Professor Miller has explained with regard to Rule 23(e) (58 F.R.D. at 331):

> "Another exception to the mandatory notice requirement in Rule 23(e) occurs when the dismissal is not voluntary. Inasmuch as an involuntary dismissal presumably cannot involve collusion or benefit the representative plaintiffs at the expense of the remaining class members, the protection afforded by giving notice to the absentees is not required."

Rule 23(e), as noted below,* contains the identical provisions as Rule 23.1 regarding notice and judicial approval.

Wolf, supra (348 F.2d 994), illustrates this point. After a shareholder had brought a derivative action against corporate officers and directors for violations of the federal

* Originally, Rule 23 covered both class and derivative actions. In 1966 Rule 23 was amended and a new rule—Rule 23.1—was adopted to deal solely with derivative actions. Rule 23.1 did not change the provisions dealing with dismissal or compromise of shareholders' actions; the last sentence of Rule 23.1 is virtually identical to new Rule 23(e) and essentially continues the law under prior Rule 23(c). See 3B Moore's *Federal Practice* ¶ 23.80[1] at 23-505 (2d ed. 1978).

securities laws, the corporation negotiated settlements directly with some of the defendants. The derivative plaintiff moved to enjoin the settlements, claiming that they were legally ineffective without notice to the stockholders and approval by the Court pursuant to then Rule 23(c) [now Rule 23.1]. The Court of Appeals affirmed the denial of an injunction on the ground that the judicial approval and notice requirements of the rule did not apply, since the rule was intended to protect against *voluntary* dismissals by shareholder plaintiffs, not *involuntary* dismissals over their objection. Judge Friendly wrote (348 F.2d at 996-97):

> ". . . If we go behind the letter to the prime 'mischief and defect' the rule was intended to prevent, to wit, 'private settlements under which the plaintiff stockholder and his attorney got the sum paid in settlement, and the corporation got nothing,' [citation omitted], the instant case likewise is not within it.
>
> * * *
>
> ". . . When the acquiescence of a derivative plaintiff to a dismissal or a consent judgment has in effect been purchased by the defendants, the supposed vigorous champion of the shareholders at large has been retired; far from policing the disposition of the corporate claim, he may well assist in seeing that the news does not leak out to stir other shareholders to inquiry. No such silencing of the derivative plaintiff occurs when the corporation settles out of court with some of the defendants. Indeed, he is the very person most likely to challenge the settlement. . . ." *

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* Judge Friendly also noted (348 F.2d at 997 n.4):

> "The SEC urged Congress to provide in the Investment Company Act of 1940 that such companies be forced to seek court approval before settling claims against 'insiders' that could be the target of derivative suit; the provision was not enacted. [citations omitted]"

The same considerations apply at bar, where plaintiffs have vigorously opposed the dismissal.

Auerbach v. *Bennett*, 64 A.D. 2d 98, 408 N.Y.S.2d 83 (2d Dept. 1978), is mischaracterized by plaintiffs (Respondents' Brief, p. 50). First, as a state court case, *Auerbach* did not deal with Rule 23.1. Moreover, in the very next sentence following the quotation by plaintiffs, the Court added (64 A.D.2d at 108, 408 N.Y.S.2d at 88):

> "That is not to say that after the usual discovery and deposition stages of the action have been completed, summary judgment might not be the appropriate vehicle to terminate the action when the record shows that the disinterest of the directors was not refuted, the underlying facts were thoroughly investigated and cogent reasons existed in support of the decision of the committee."

The Court held merely that (*id.*):

> "On *this* record, and at *this* stage, we think that summary judgment should not have been granted." (emphasis supplied)

The other cases under Rule 23.1 cited by plaintiffs are inapposite. All involved applications by plaintiffs for *voluntary* dismissals of derivative actions as a result of negotiated settlements. None of those cases involved *involuntary* dismissals over the vigorous opposition of the derivative plaintiffs.*

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* Plaintiffs incorrectly suggest that the cases relied upon by defendants do not apply since "*defendants* here seek dismissal based on the allegedly voluntary act of the minority directors" (emphasis supplied) (Respondents' Brief, p. 44n.*). This obviously misstates the test in those cases, namely whether the *plaintiff* (as the intended guardian of his fellow shareholders' rights) is voluntarily permitting dismissal of the claim, suggesting the possibility of collusion on the part of the plaintiff's counsel.

Plaintiffs argue, in Point IV B, that the SEC's proposal ". . . would wreak havoc with the traditional role of the courts in derivative litigations; it would also result in extensive, time-consuming and litigation-delaying hearings at the behest of minority directors." (Respondents' Brief, p. 50). This is most extraordinary since plaintiffs contend elsewhere in their brief that the District Court should have ordered the mailing of notice to all shareholders and conducted "a full exploration of the relevant circumstances, including the merits" after "discovery on the merits" to weigh the propriety of the dismissal under Rule 23.1 (Respondents' Brief, p. 43).

The SEC correctly recognizes that disinterested directors of a mutual fund do have the power to terminate stockholder derivative litigation (SEC Brief, pp. 20-23). Indeed, as the SEC points out, the business judgment rule is itself "an important shareholder protection device" (SEC Brief, p. 22).

The SEC sets up three factual criteria for recognition of directors' business judgment: (1) the directors must be independent; (2) the directors must be fully informed, and (3) their judgment must be reasonable (SEC Brief, pp. 16-20.) The SEC acknowledges that its first two criteria were met in this case (SEC Brief, pp. 23-24) but suggests that the District Court failed to make an express finding as to its third criterion, i.e. reasonableness.

Although the SEC has suggested that the District Court did not pass upon the reasonableness of the disinterested directors' determination (SEC Brief, p. 8), the second opinion of the District Court specifically referred to the quorum's decision as "their reasoned judgment" (A.35), which is consistent with the test of reasonableness advanced by

the SEC, i.e. whether the directors made "a reasoned determination" (see SEC Brief, p. 20 n.16).*

Moreover, necessarily implicit in the finding of good faith by the District Court was the conclusion that the judgment exercised by the disinterested directors was reasonable.

In any event, the SEC itself agrees that a determination of the reasonableness of the directors' action at bar can readily be made from the record now before this Court. In fact, the SEC states (SEC Brief, p. 25 n.21):

> "Although we suggest a remand, this Court could determine reasonableness if it wishes, because that determination involves only the application of a legal standard to a documentary record."

We do not believe a remand is necessary or appropriate here. No charge is or could be made here that the exercise of business judgment in this case falls "outside the permissible bounds of the directors' sound discretion." See *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir. 1978). The record evidence overwhelmingly establishes that the directors made a sound, reasoned business judgment (A.77-79, 131-136, 139-141), that they were fully informed (A.81-116, 118-126, 128-130, 138-139) and that they were entirely independent (A.142-143, 147-150).

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* In *Alleghany Corp.* v. *Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966), the Court of Appeals for the Second Circuit upheld a business judgment not to pursue litigation based upon many of the same factors relied upon by the disinterested directors at bar (344 F.2d at 573 n.1) as a "sound business judgment."

Reply to Point V

Plaintiffs argue, in Point V A, that the disinterested directors were not independent (Respondents' Brief, pp. 56-62). Plaintiffs, alone, are of this view.

The District Court found, after extensive discovery on the issue (A.28):

> "Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently." (emphasis supplied)

The Court of Appeals, which did not disturb the District Court's findings, wrote (A.48):

> "We have no doubt that the five minority directors acted in good faith in all that they did."

The SEC, which examined the record in this case and filed an *amicus* brief wrote (SEC Brief, p. 23):

> "We do not question the district court's finding that the disinterested directors were in fact independent."

Notwithstanding these unanimous judicial and agency findings and views, and notwithstanding the overwhelming record evidence that the disinterested directors of Fundamental were truly independent, plaintiffs continue to carp and cavil about the disinterested directors.

For example, plaintiffs have four pages of charts to show that the disinterested directors were allegedly "hand-picked" by Anchor (Respondents' Brief, pp. 56-59). The fact is that all of the disinterested directors were proposed, in the first instance, by a Directors' Qualifications Committee, and two of the three members of that committee were, at all times, disinterested directors as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940. Next, all of the disinterested directors were nominated for election by the full board of directors, which, at all times, consisted of a majority of disinterested directors. Finally, all of the disinterested directors were elected by the stockholders as their lawful representatives (A.142-143). The root of the error of plaintiffs' position is their mistaken notion that merely by naming a disinterested director a defendant in a derivative action, he or she, without more, is disqualified, both prospectively and retrospectively, from functioning as a director. If this were the rule, plaintiffs in derivative actions could control the corporate destiny without any restraint by merely naming all directors as defendants.

Plaintiffs also contend that the five disinterested directors were not independent because of "a long history of social and business relationships with a number of defendants" (Respondents' Brief, p. 59). This is an utter distortion, as a reading of the record shows. The District Court made this finding (A.28):

> "Although each of the minority directors knew someone on the Board at the time he or she was nominated, the relationships which existed between the minority directors and the defendant directors were *de minimis*. . . ."

At another point in their brief, plaintiffs assert that "Each member of the quorum had been screened, selected and nominated for office by Anchor and the individual defendants who, as majority directors, at all times had the absolute power to effect their removal." (Respondents Brief, p. 8). Plaintiffs offer no citation of authority

—either record or legal—for these assertions. The fact is that Anchor did not screen, select or nominate any director (A.142-143) and neither Anchor nor any combination of the so-called majority directors had any power to remove the so-called minority directors—all directors served, in accordance with law, until their terms expired and their successors were duly elected and qualified. Delaware Corporation Law, § 141 (b) and (k), Del. Code tit. 8, § 141(b) and (k) (1975).

Plaintiffs also argue, in Point V B, that the action has "merit" (Respondents' Brief, p. 63). The disinterested directors and their special counsel, Judge Fuld, found otherwise (A.82), but the important point is that they carefully *considered* the merits, as the District Court found (A. 36).* Even assuming, *arguendo,* that the action has "merit", that is only one of many factors to be considered in arriving at a sound business judgment. And the law is, and always has been, as stated in *Cramer, supra* (582 F.2d at 275):

> "Even if a particular suit has some merit, the litigation costs and the adverse effect on the business relationship between the corporation and the potential defendant might outweigh any potential recovery in the lawsuit."

* Plaintiffs erroneously contend that Judge Fuld "overlooked" *Matter of Winfield & Co., Inc.* (Respondents' Brief, p. 63). First, there is no evidence in the record that Judge Fuld failed to consider that case. Second, that case is not in point: it was an uncontested SEC enforcement proceeding involving an investment adviser who, in recommending purchase of restricted securities by the fund, relied on unsubstantiated representations of other persons, described by him as "research sources" but who, in fact, had a substantial economic interest in such restricted securities. No such facts are present here: Anchor relied, among other things, on the "Prime" rating of Penn Central by NCO (a subsidiary of Dun & Bradstreet), the foremost independent commercial paper rating agency in the country (A.86, 122). In addition, Anchor was knowledgeable about Penn Central since Penn Central Company had been a recent equity holding of Fundamental (A.125). Finally, since *Matter of Winfield & Co., Inc.*, was an SEC enforcement proceeding, no finding of *scienter* was necessary for liability. To the contrary, in a private damage action such as this one, as Judge Fuld correctly concluded, proof of "fraudulent intent" is essential to recovery (A.94).

This Court long ago stated in *Corbus* v. *Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 463 (1903):

> "The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right."

Plaintiffs make numerous overstatements and misstatements throughout their brief with respect to the merits. For example, plaintiffs assert that the Court of Appeals made "a further *finding* that the plaintiffs' claims were substantial and *meritorious*" (emphasis supplied) (Respondents' Brief, p. 10). This is false. The Court of Appeals nowhere *found* or even stated that plaintiffs' claims were *meritorious*. The Court of Appeals said only ". . . we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses." (A.43) This hardly constitutes a finding of meritoriousness of plaintiffs' claims by the Court of Appeals.

Plaintiffs also misleadingly assert that Anchor "violated two out of the three investment guidelines which it had established to safeguard the Fund", i.e., the 10% guideline and the buy-back guideline (Respondents' Brief, p. 3). This is false. As to the 10% guideline, Fundamental purchased $20 million out of a total of $200 million of Penn Central commercial paper outstanding, and, thus, was within its guideline (A.109-110, 122). And, as to the buy-back guideline, Anchor believed on the basis of its prior talks with Goldman, Sachs & Co., which had always bought back paper previously, that it had such an understanding (A.84, 121-122). Goldman, Sachs & Co., under the pressure of the situation, simply failed to honor its commitment in this case (A.124).

Other examples of overstatement and misstatement by plaintiffs with respect to the merits abound. However, since they are essentially an attempt to re-argue facts found by the District Court, and do not affect the fundamental issue before this Court, no further response will be made in this brief.

Plaintiffs next argue, in Point V C, that the minority directors were misinformed by Mr. Haire and by Mr. Souther (Respondents' Brief, pp. 68-73). The District Court made express findings to the contrary.

As to Mr. Haire, the District Court found (A.35):

> "The court is of the opinion that Haire's statements are neither inconsistent nor misleading. His assertions only indicate that he believed it would have been difficult, but not impossible, for Anchor to have continued its service to the Fund faced with this lawsuit. The affidavit of the disinterested quorum chairman shows only that the minority directors reached a different conclusion: that prosecution of the suit 'would necessarily cause the Fund to seek to obtain a different investment adviser immediately.' "*

As to Mr. Souther, the District Court found that his participation was "equally innocent" (A.32). The full findings as to Mr. Souther by the District Court are set forth at A.32-33 and will not be reprinted here in the interest of brevity. Plaintiffs now also claim that a memo-

* The claim that Mr. Haire "misled" the disinterested directors is exposed as baseless by a review of the discovery proceedings. Plaintiffs read Mr. Haire's statement to Mr. Stephens, who testified flatly "I *differ* with Mr. Haire on his conclusion." (Stephens Tr. 116-119.) Mr. Haire had one view as to whether Anchor could continue to act; the disinterested directors had another view. Mr. Haire did not mislead anyone about anything.

randum prepared for the disinterested directors, at their request, by Mr. Souther's firm (A.158-161), was "biased"; however, the memorandum is factually and legally correct and plaintiffs did not and could not demonstrate otherwise.

The final argument raised by plaintiffs in Point V D, to wit, that because Anchor is no longer the investment adviser, the continued prosecution of this action cannot possibly injure Fundamental, has been dealt with earlier in this Reply Brief at pp. 3-4. The adversary relationship was just one of many factors considered and relied upon by the disinterested directors in reaching their conclusion that this derivative litigation was contrary to the best interests of Fundamental and its shareholders and should be terminated. The numerous other factors are set forth in the moving affidavit of Mr. Kendall (A.77-79), the minutes (A.137-141) and the letter of Mr. Stephens (A.131-136).

* * *

Respondents' Brief is, in sum, a "skillful assemblage of suspicions, surmises and conjectures."* Reflection upon the true issue in this case leads one inescapably back to this proposition: plaintiffs and the Court of Appeals would have this Court rule that disinterested directors of a mutual fund, who constitute a quorum and have been found to be truly disinterested and independent, are incapacitated, *as a matter of law,* from exercising their business judgment to terminate a stockholder's derivative action they find to be contrary to the best interests of the fund and its shareholders. The *per se* disqualification of the disinterested directors is in conflict with the intent of Congress as expressed in the Investment Company Act of 1940 and does violence to sound and logical principles of corporate governance.

* *Marco* v. *Bank of New York,* 272 F. Supp. 636, 640 (S.D.N.Y. 1967), *aff'd,* 398 F.2d 628 (2d Cir. 1968).

CONCLUSION

The judgment of the Court of Appeals should be reversed and the Complaint should be dismissed.

Respectfully submitted,

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